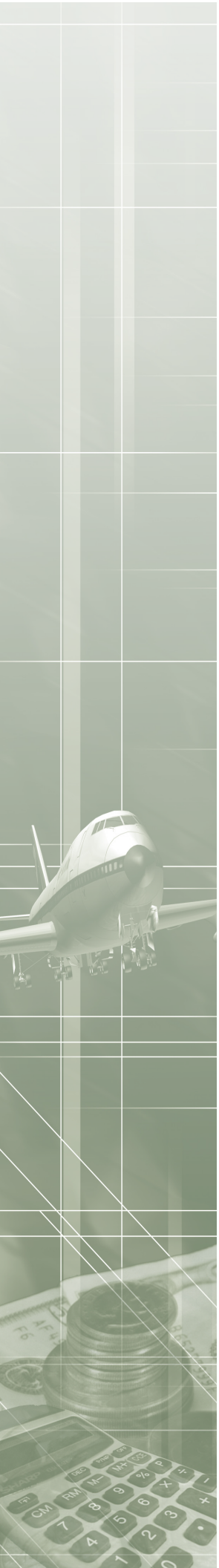

10. INDIRECT COSTS

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10.1 OVERVIEW OF INDIRECT COSTS

This chapter addresses the terms, The purpose of this chapter is to give the analyst a broad based explanation of how indirect costs are accumulated, allocated, and projected, and to understand the rules, regulations, and guidelines that impact indirect costs. Table 10-1 lists common terms and definitions.

Table 10-1. Common Terms and Definitions

Terms	Definitions
Indirect Costs	Any cost that cannot be directly identified with a single final cost objective but can be identified with two or more final cost objectives or an intermediate cost objective [Cost Accounting Standards (CAS) 418.30(3)].
Overhead	Indirect costs related to specific operations, such as general product lines, organizational groups, and groups of contracts.
General and Administrative (G&A) Expense	Any management, financial, and/or other expense incurred by or allocated to a business unit for the general management and administration of the business unit as a whole. [CAS 410.30(6)]
Business Unit	Any segment of an organization, or an entire business not further divided into segments. [CAS 410.30(2)]
Home Office Expense	The expenses of an office responsible for directing or managing two or more, but not necessarily all, segments of an organization. [CAS 403.30(2)]
Indirect Cost Pool	A logical grouping of incurred costs identified with two or more objectives but not specifically with any final cost objective. [CAS 418.30(4)]
Cost Objective	A function, organizational subdivision, contract, or other work unit for which cost data are desired and for which provision is made to accumulate and measure the cost of processes, products, jobs, capitalized projects etc. [CAS 410.30(4)]

Disclosure Statements

A disclosure statement is a document that details the business unit's cost accounting policies and procedures, including indirect cost allocation methods. When reviewing business unit specific indirect costs, the disclosure statement is an invaluable resource. The disclosure statement will define the type of indirect costs used by the business unit and the composition of those costs. For more information regarding disclosure statements refer to Chapter 14, "Cost Accounting Standards".

10.2 COMPOSITION OF INDIRECT RATES

$$\textit{Indirect Rate} = \frac{\textit{Indirect Cost Pool}}{\textit{Allocation Base}}$$

As shown in the equation above, an indirect rate results from dividing an indirect cost pool by the appropriate allocation base. An indirect rate is usually expressed as a percentage. Knowing how cost pools and allocation bases interact is necessary to achieve an understanding of indirect rates.

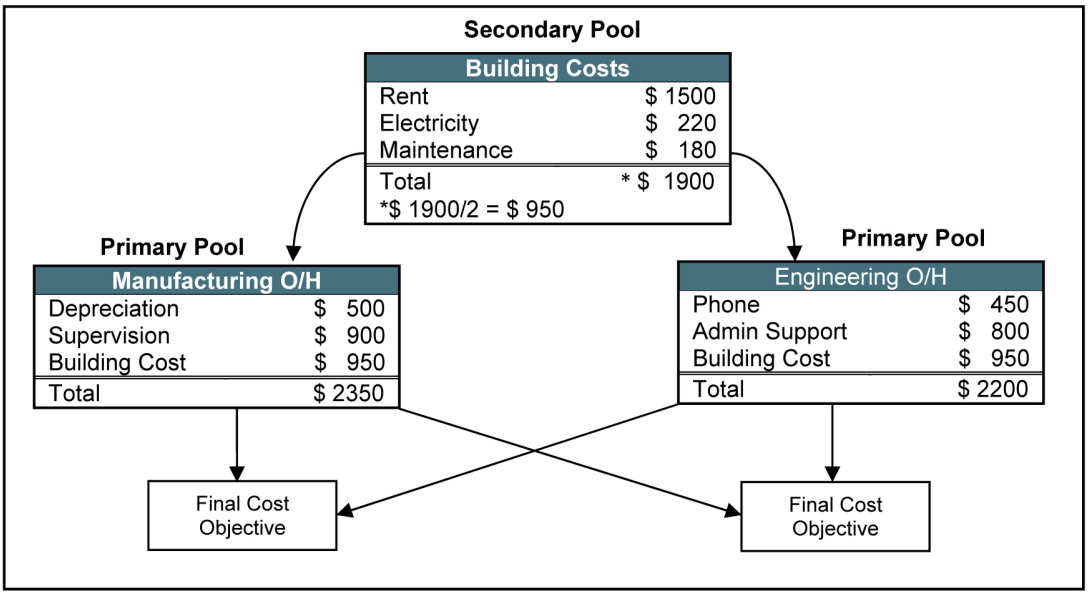
10.2.1 Indirect Cost Pools

An indirect cost pool accumulates indirect costs into homogeneous groups for purposes of allocating them to cost objectives. A homogeneous indirect cost pool is one in which all costs have a similar beneficial or causal relationship to the cost objectives. If allocated individually, all the costs in a homogeneous indirect cost pool would be allocated to the same cost objectives in the same way they were allocated as a group. An organization should have enough indirect cost pools so as to achieve homogeneity within each pool. The pools may be primary pools or secondary pools.

Primary pools are used to develop the indirect rate and either relate to specific operations of the firm or relate to the overall operation and management of the firm. They consist of logical cost groupings with due consideration of the reasons for which the costs were incurred. When determining which cost belongs in which pool, the key question is, "Who benefits from the expense?"

A secondary pool is an intermediate pool used to ensure that costs are distributed properly to cost objectives which may not be final cost objectives. The costs in a secondary pool are often allocated to other secondary pools or to primary pools. For example, the engineering and manufacturing divisions each use 50% (based on square footage) of the same building. The costs of the building are indirect since they cannot be directly charged to a single final cost objective and are collected in a secondary pool since they are shared by two divisions which have their own primary pools. The secondary pool is allocated between the two primary cost pools for manufacturing and engineering. Since both cost centers receive an equal benefit from the building, both should share the cost equally. Figure 10-1 depicts the relationships between the example of secondary and primary cost pools.

Figure 10-1. Secondary and Primary Cost Pools



Besides ensuring homogeneity within an indirect cost pool, the analyst should also ensure that the costs are allowable under the FAA Contract Cost Principles and the CAS. Unallowable costs should be accounted for separately from allowable costs. Only allowable costs are to be included in indirect cost pools used to develop allowable rates.

10.2.2 Allocation Bases

Assigning an indirect cost pool to a particular allocation base depends upon the types of costs included in the pool, and whether the base provides a reasonable representation of the relative consumption of pooled indirect costs by direct cost activities. For example, direct labor hours may not be an appropriate allocation base for the building expenses in Figure 10-1 because there is no clear relationship between the two. The square footage of the building that each division occupies is a more appropriate base since the cost of building expenses depends on the size of the building.

NOTE:
CAS 418 addresses allocation bases for overhead and CAS 410 discusses allocation bases for G&A expense.

Normally, there are many factors to consider when selecting an allocation base, and no rules cover every situation. Determining an appropriate and reasonable allocation base depends on the company's accounting system and to some extent is a matter of judgment. Essentially, an allocation base should 1.) result in an equitable allocation of indirect costs to cost objectives, 2.) be consistently applied over time and among cost objectives, and 3.) comply with generally accepted accounting principles (GAAP) and CAS (if applicable). Some

possible allocation bases are sales, direct labor dollars, machine hours, square feet, usage etc.

In addition, the allocation base must include all costs, even those not allowable under Government contracts. The fact that a cost is unallowable under Government contracts does not mean that it receives no benefit from indirect costs. All items properly included in an indirect cost base should bear a pro-rata share of indirect costs irrespective of their acceptance as allowable contract costs.

The method of allocating costs to a particular base requires close examination when any of the following conditions exists:

- The cost patterns of work under the contract are substantially different from the contractor's other work,
- Significant changes occur in the nature of a contractor's business, the extent of subcontracting, fixed-asset improvement programs, inventories, the volume of sales and production, manufacturing processes, the contractor's products, or other relevant circumstances, or
- Indirect cost groupings developed for a contractor's primary location are applied to off-site locations. Separate cost groupings for costs allocable to off-site locations may be necessary to permit equitable distribution of costs based on the benefits accruing to the several cost objectives.

10.3 TYPES OF OVERHEAD

Overhead is a type of indirect cost pool that is related to the specific operations of the firm. The three major types of overhead are material, labor, and fringe benefit (if not included in labor overhead). The three overheads differ in regard to which costs they include and how they are allocated.

10.3.1 Material Overhead

Material overhead, sometimes called material handling, includes the expenses related to acquiring, transporting, receiving, inspecting, handling, and storing materials.

Different options exist for collecting and allocating indirect material-related costs. For example, they can be counted as part of labor overhead or as a separate pool. A common method is to have a separate material overhead pool. Since material costs can vary significantly from contract to contract, a separate pool ensures that overhead costs are charged commensurate with material cost in the contract.

10.3.2 Labor Overhead Rates

Labor overhead typically can include:

- **Indirect labor,** consisting of supervision, inspection, maintenance, custodial, and other personnel whose labor is not charged directly to a production or an operation;
- **Costs associated with labor,** such as social security, unemployment taxes, shift and overtime premiums, and fringe benefits (if not a separate indirect or direct cost pool);
- **Indirect supplies,** such as small tools, grinding wheels, janitorial supplies, and lubricating oils; and
- **Fixed charges** including depreciation, insurance, rent, and property taxes.

WARNING:
Employee wage rates sometimes include additional labor related costs, resulting in a loaded rate. When loaded wage rates are used, additional overhead should not be added. If it is, the contractor may be double-counting costs. Lack of a separate account for such costs is one indication that a contractor may have included overhead in the wage rate.

Labor overhead is often segregated by labor function, such as engineering and manufacturing (factory) overhead, where each function maintains a separate overhead rate. The main reason for this separation is that various functions perform separate operations which require different types of costs. Manufacturing costs typically include equipment maintenance and depreciation, quality control, and shop floor supervision whereas engineering costs may be limited to office space, telephones, personal computers, and office-related support. However, the exact method for charging labor and labor overhead will vary based on the company's accounting system.

10.3.3 Fringe Overhead

As mentioned above, fringe benefits may be included in labor overhead, but often companies have a separate pool for fringe benefits. FAA AMS Procurement Guidance T3.3.2D.2.4.m (Contract Cost Principles) defines fringe benefits as allowances and services provided by the contractor to its employees as compensation in addition to regular wages and salaries. They include, but are not limited to, the cost of vacations, sick leave, holidays, military leave, employee insurance, and supplemental unemployment benefit plans. Fringe benefits are allowable if they are reasonable and required by law, an employer-employee agreement, or established company policy.

The amount of fringe benefits that a company is required to provide its employees has been impacted by socioeconomic laws. Congress has passed

several laws establishing labor requirements in the areas of safety, health and sanitation, minimum wages, maximum hours, equal employment opportunity, age discrimination, and many others. The laws, acts of Congress, and executive orders that pertain to fringe benefits are too numerous to mention all of them. The *Service Contract Act* and the *Davis-Bacon Act* are described below.

Service Contract Act

The *Service Contract Act* regulates the wages and benefits given to employees on service contracts. It was implemented to prevent situations where the contractors competed for labor intensive contracts by reducing the wages and benefits of employees. The Act applies to U.S. contracts principally for the furnishing of services through service employees. Service employees are those individuals not defined as executives, administrators, or professionals by 29 CFR 541 and can include employees in certain "white collar" jobs. Examples of covered contracts include those providing housekeeping services, food service contracts, snow and trash removal contracts, and facility operations contracts.

The Service Contract Act affects indirect costs because it requires contractors to provide fringe benefits that are greater than or equal to the prevailing amount for a given locality. The fringe benefits provided fall within two categories as part of the Department of Labor's (DOL) wage determinations.

The first category, **vacation and holidays**, are provided as days required. Vacation is usually expressed as the number of days or weeks off to which an employee is entitled after a stated time period. Holidays are expressed in the number of days off per year an employer is required to give employees as holidays. While most wage determinations specify eleven holidays, some localities may require as few as nine or as many as thirteen.

The second fringe benefit category is **health and welfare**. This category includes fringe benefits such as health, disability and life insurance, sick leave, and retirement. On government contracts, only bona fide fringe benefits are allowed as part of indirect costs. To qualify as bona fide Health and Welfare benefits, money for these benefits must be irrevocably contributed by a contractor to a trustee or a third party such as an insurance company. Any discretionary benefits such as discretionary contributions from profit (besides what is required in the company's defined contributions plan) to 401(k) plans are not bona fide health and welfare benefits for purposes of complying with this act. Any benefit required by federal, state, or local law, such as unemployment compensation under the *Federal Unemployment Tax Act (FUTA)*, is not considered bona fide fringe benefits. Finally, the cost of

administration for benefits is considered a bona fide fringe benefit and is allowable as an indirect cost.

The contractor may elect to pay cash in-lieu of the benefits or a combination thereof. When analyzing fringe benefit rates, the analyst should ensure that the contractor is either providing the minimum benefit or paying the equivalent in cash. This analysis involves looking at the compensation plan and ensuring that the proper number of vacation and holiday days is given to those employees covered by the *Service Contract Act*. To assess the adequacy of the Health and Welfare benefits, the analyst needs a detailed fringe benefit breakout. If the contractor is paying some or all benefits in cash, the analyst should ensure the amounts are adequate. Case Study 10-1 shows the computation of the cash equivalent of paid holidays.

CASE STUDY 10-1. COMPUTATION OF HOURLY PAYMENT OF CASH IN LIEU OF HOLIDAYS

Background:

- Hourly pay: $10.00
- Number of holidays: 10
- Ratio of number of holidays multiplied by hours in a day multiplied by hourly pay to hours in year
- DOL specifies a 2,080-hour year

Objective: Compute the hourly payment of cash in lieu of holidays.

Calculation:
[(10 x 8) x $10] / 2,080 = $0.39/hour

Davis-Bacon Act

The *Davis-Bacon Act* provides that laborers employed under a Government contract for construction, alteration, or repair of public buildings receive no less than the prevailing wage rates and fringe benefits as determined by the DOL. This coverage also includes drivers who transport material and equipment back and forth from the construction job site.

The *Davis-Bacon* benefit administration is very similar to that discussed under the *Service Contract Act*. In fact, the analysis is the same. The major difference is that the contracting officer is responsible for enforcement of the Davis-Bacon wage determinations.

10.4 G&A EXPENSE

G&A expenses are the costs for operating a business unit's corporate activities. These costs are typically not within the division manager's realm of control and are not allocable to any single division.

The G&A cost pool typically includes labor for corporate officers, clerical personnel, accountants, human resources personnel, purchasing agents, and attorneys. It also includes the cost of corporate level equipment, and other costs such as office supplies, utilities, interest expense, and legal costs. G&A may not include unallowable costs such as interest, contributions to charity, entertainment expenses, fines and penalties, losses on other contracts, and federal income taxes.

G&A is allocated only to final cost objectives. The base used in allocating G&A should represent the total activity of a typical cost accounting period. In commercial practices, the cost of sales is commonly used as a base for G&A. Cost of sales, however, is generally not an allowable base in Government contracting. Since cost of sales excludes items produced for inventory, it is not a measure of total activity. Items produced for stock or product inventory are included as final cost objectives in the period in which the work is done, and therefore, are to be included in the cost input base. The boards of appeal, however, have allowed cost of sales as a G&A base in certain circumstances, such as during an accounting period where there were no major changes in inventory.

For CAS covered Government contracts, the G&A base may be one of three options: total cost input, value-added cost input, and single element cost input.

- **Total cost input (TCI)** is generally accepted as a measure of total activity. Total cost input includes all costs, both direct and indirect.
- **Value-added cost input** is the total cost minus material and subcontracts. Value-added is appropriate to use when inclusion of material and subcontract costs in the base would distort G&A allocation and where costs other than direct labor are significant measures of total activity.
- **Single element cost input** base (e.g., direct labor dollars) represents total activity when there is no other significant cost element or when other significant elements vary in the same proportion to total costs. The following is an example of a single element base.

EXAMPLE: SINGLE ELEMENT BASE

The ABC Corporation has several service contracts with the Government. The work performed is labor intensive with very little material and subcontract expenses. In a typical accounting period expenses may be as follows.

Cost Element	Dollars	% of TCI
Direct Material	1,000	0.3%
Direct Labor	295,000	83.1%
Subcontract Expense	0	0.0%
Overhead (20% of prime cost)	59,200	16.6%
Total Cost Input	355,200	100.0%

Since direct labor cost is 83% of total cost input and no other cost elements are significant, ABC uses direct labor dollars as the G&A allocation base.

Non-CAS covered contracts have the option of using cost of goods sold as the G&A base. Using cost of goods sold is advantageous because data are readily available from accounting records without requiring a separate calculation. However, cost of goods sold is an acceptable base when it is equal to total cost input. When G&A is more closely related to production than to distribution or sales, cost of goods sold is an unacceptable base. A closer relationship to production means that the costs contained in the G&A pool are linked to goods produced rather than those sold. This occurs when there is a long manufacturing cycle or when goods are produced for stock. Under these circumstances a total cost input, valued-added cost input, or single element cost input base would be appropriate.

10.5 ANALYSIS OF INDIRECT RATES

Often, proposals span multiple years which requires understanding the projection of future indirect rates. As discussed in the previous section, an indirect rate is composed of indirect costs and an allocation base. Therefore, projecting indirect rates requires projecting indirect costs and projecting business volume upon which the allocation base and indirect cost projection depend. Further, the analyst should understand the relationship between indirect costs and business volume.

10.5.1 Indirect Cost Behavior

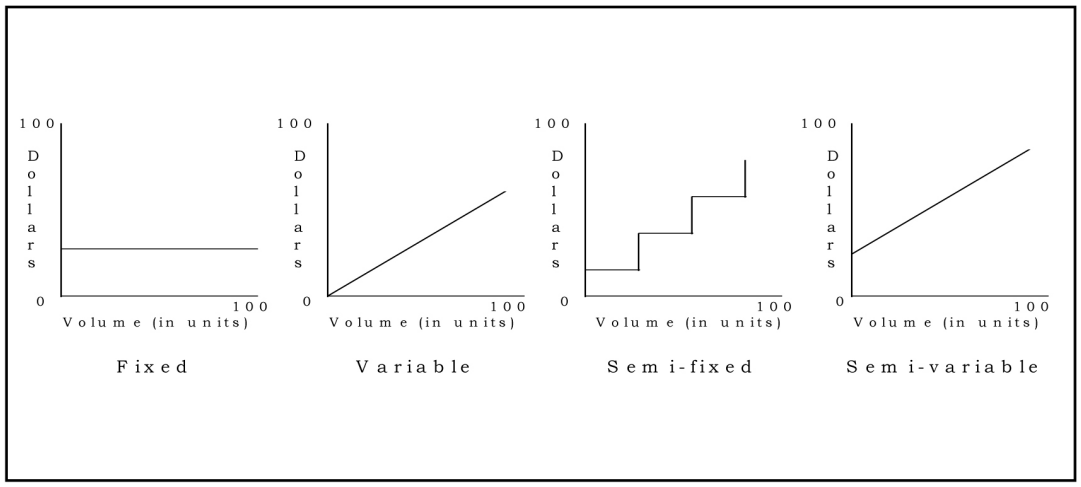
Indirect cost behavior refers to the interaction between indirect costs and volume. Due to the nature of indirect costs, they generally increase as volume increases and decrease as volume decreases, but to what extent indirect costs increase or decrease depends on the nature of the cost. Knowing how an indirect cost will react to a change in volume is important for such pricing

actions as equitable adjustments and terminations and for the projection of indirect costs.

Fixed Versus Variable Indirect Expenses

Costs can be classified as fixed, variable, semi-fixed, or semi-variable. **Fixed costs** do not change (in the short run) when business volume changes. Typical fixed costs are rent, insurance, and depreciation. Conversely, **variable costs** experience changes proportional to changes in business volume. Variable costs may include fringe benefits, unemployment taxes, and social security. Between the two cost extremes are semi-fixed and semi-variable. **Semi-fixed costs** are fixed over some range, but they will vary at critical points. An example of a semi-fixed cost is the labor rate paid to a supervisor who can oversee a maximum of 5 people. One supervisor is needed for a staff of five or less; two supervisors are needed if the staff grows larger than five. **Semi-variable costs**, such as electricity and telephone costs, generally have a fixed minimum charge. Once the minimum is reached semi-variable costs will behave like variable costs. The best way to note the differences is graphically. Figure 10-2 contains graphs showing how the costs behave in reaction to changes in volume.

Figure 10-2. Graphic Comparison of Indirect Cost Behavior



Because all costs do not change when the volume changes, there is a lag time between a change in business volume and its full impact on indirect costs. After an increase in volume, the company will not rush to buy new equipment and facilities until it is sure the volume expansion will last. Similarly, when the volume drops off, there is a reluctance to cut costs. When a significant change in volume occurs, there may be an initial increase or decrease in the indirect rate.

The issue of fixed versus variable cost poses a problem in price adjustments. Since fixed costs do not increase or decrease when contract costs change, there

is some belief that a price adjustment should not include these costs. Court cases and board decisions regarding this issue are mixed. A solution to the problem may be the calculation of a new indirect rate when there is a major change and the use of the original rate when the change is minor.

Methods of Predicting Indirect Cost-Quantity Relationships

A cost-quantity relationship is the degree to which volume affects cost. Predicting a cost-quantity relationship involves analysis to determine the dollar amount of fixed costs and the factor by which variable costs change. There are four methods that can be used to predict cost-quantity relationships.

The J.H. Williams Method

The J.H. Williams method compares costs at minimum and maximum volumes to determine the amount of fixed costs. The process to conduct the J.H. Williams method is as follows:

- **Step 1.** Determine a minimum and maximum volume.
- **Step 2.** Estimate the total indirect cost for each volume.
- **Step 3.** Subtract the minimum volume from the maximum volume and the minimum cost from the maximum cost.
- **Step 4.** Divide the difference in cost by the difference in volume to arrive at the unit variable cost percentage.
- **Step 5.** Multiply the minimum and maximum volumes by the unit variable cost percentage.
- **Step 6.** Subtract the total variable costs from their respective total costs to derive the fixed-cost portion of the expense item.

The following is an example of the J.H. Williams method.

EXAMPLE: J.H. WILLIAMS METHOD

	VOLUME (in hours)	TOTAL INDIRECT COST	5% (4) VARIABLE COST	FIXED COST
Maximum	750,000 (1)	$60,000 (2)	$37,500 (5)	$22,500 (6)
Minimum	250,000 (1)	35,000 (2)	12,500 (5)	22,500 (6)
Difference	500,000 (3)	$25,000 (3)	$25,000	$ 0

Note: *Numbers in parentheses correspond to the above steps.*

The Standby Cost Method

The standby cost method estimates the fixed costs that would continue if there is a temporary shutdown. The remaining cost is assumed to be variable in nature. Due to the arbitrary nature of this method, it is not as accurate

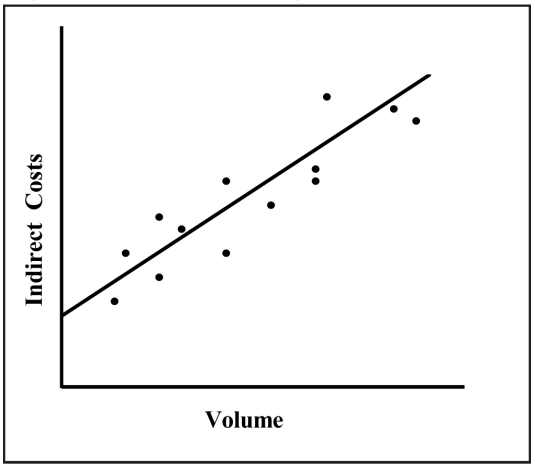
as other methods, but it has the advantage of being quick and easy. See the example below.

EXAMPLE: STANDBY COST METHOD	
Total indirect cost	$75,000
Costs continuing after temporary shutdown:	
Rent	$20,000
Insurance	$ 5,000
Depreciation	$10,000
Total Fixed costs	$35,000
Remaining/Variable costs	$75,000 - 35,000 = $40,000

Graphic Correlation

Graphic correlation uses a scatter diagram to construct a cost curve by visual inspection. The analyst plots experienced costs on a scatter diagram then draws a line through the middle of the dots. The intersection of the cost curve and the vertical axis represents the fixed portion of the expense item. A sample scatter diagram is presented in Figure 10-3.

Figure 10-3. Scatter Diagram



Least Squares

Least squares is a more scientific application of the graphic correlation approach, using a least squares regression calculation to develop the formula for the appropriate cost curve. The formula is based on determining the y-intercept (fixed costs) and the slope (variable costs). Least squares regression is described in more detail in Chapter 15, "Quantitative Analysis Techniques".

10.5.2 Forward Pricing Rate Agreements (FPRA) & Forward Pricing Rate Recommendations (FPRR)

Under certain circumstances, the analyst may not need to review a contractor's indirect costs. If the contractor has a Forward Pricing Rate Agreement (FPRA) or if the Administrative Contracting Officer (ACO) has issued a Forward Pricing Rate Recommendation (FPRR), the analyst should obtain these rates and use them to derive the FAA-evaluated indirect costs. Further, if a Defense Contract Audit Agency (DCAA) audit or rate verification is requested, the analyst should use the DCAA recommended rates.

FPRAs and FPRRs can cover a variety of rates including labor rates, indirect costs, material obsolescence and usage, spare parts provisioning, and material handling.

The process of reaching an FPRA or FPRR begins when the contractor proposes forward pricing rates. Proposed forward pricing rates are developed from the contractor's budget and planning activities. Once the Government receives a contractor's proposed forward pricing rates, a Government audit is conducted to determine recommended rates. Based on the analysis, the ACO may publish a FPRR. FPRRs are not binding to the contractor. They are established to facilitate the development of a Government negotiation objective.

A FPRA is a formal bilateral agreement where the contractor agrees to propose and the Government agrees to accept the negotiated rates for proposal pricing and negotiation. FPRAs are useful when a contractor interacts frequently with the Government. The use of an FPRA can speed up the contracting process by eliminating the need to audit or analyze the rates. The ACO is responsible for monitoring the contractor's rates. Any questions concerning the rates should be directed to the ACO. Once an FPRA has been reached, any subsequent proposal should include a copy of the agreement and should describe the nature of the agreement. The analyst simply has to review the rates to ensure they match the agreed rates.

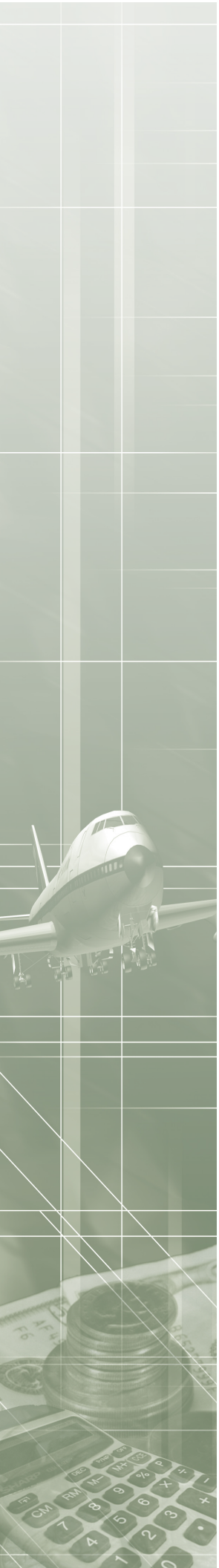
NOTE:
Even if the auditor approves of a proposed rate, the contracting officer has the discretion to make the ultimate decision about whether the rate is reasonable (unless the cognizant Administrative Contracting Officer over the contractor has made a rate determination or entered into a rate agreement, in which case FAA COs are to follow such determination).

10.5.3 DCAA Rate Verifications/Audits

Audits ensure that rates used for contracting are approved and accurate. A rate verification requires DCAA to check whether the rates in a proposal are consistent with approved or recommended rates. Rate verifications can be performed quickly and are useful when the contractor has had previous dealings with the Government and there has not been a significant change in contractor rates. An audit involves a thorough review of contractor costs and how the rates reflect these costs. For indirect costs this would entail a review of indirect pools, bases, and rates. A full-scale audit is typically used when the contractor has had no prior or recent dealings with the Government or there has been a significant change in the contractor's rates. An audit provides a more complete review of costs than a rate verification does. An audit is also used when a rate verification will not provide sufficient information.

10.6 COST REALISM AS RELATED TO INDIRECT COSTS

Cost realism analysis of indirect costs involves answering several questions related to the allocation and allowability of the various costs involved.



- **Should the cost have been included as a direct cost?** According to the General Accounting Office (GAO), the "Government cannot legally dictate how an offeror should establish his accounting system" (Cost Realism, Federal Publications). The role of the analyst when looking at a company's system of accounting for indirect costs is to review it for adequacy, acceptability, and consistency under the applicable standards. Cost realism analysis in relation to a cost being indirect or direct must involve thorough consideration of the offeror's cost pools.

- **Do indirect rates vary depending on whether the contract is performed on-site or off-site?** Answering this question requires defining on-site versus off-site. One contract may refer to the contractor's factory as on-site while another may refer to the same factory as off-site. To avoid confusion, terms such as contractor site and Government site may add clarity. If, after defining on- versus off-site, the answer to the above question is yes, did the difference in indirect costs have a bearing on where the contractor proposed to perform the work? If the site was chosen because of lower overhead, can performance reasonably occur at the chosen site? The contractor must clearly state any intent to cut costs by mixing the amount of on-site versus off-site labor. Furthermore, choice of site must be in line with the solicitation. If the solicitation specifically states or limits whether work is to be performed at one site versus another, the proposal must follow what was written in the solicitation.

- **Is the contractor reducing indirect rates by proposing unrealistic business growth?** Business growth may decrease a contractor's proposal by decreasing the indirect rates. Speculation of growth is not enough to substantiate a change in rates. Business growth estimates should be based on actual awards to the company, actual awards to a prime contractor with which the company has a binding contract, or the prospect of contracts where the company has a history of sole source procurements. Further, historical data may be used to determine if there is a trend toward business growth or decline. The best step a firm can take to ensure that its projected business growth will be deemed realistic is to include as much detail as possible. The firm should show that it has carefully considered the probability of growth and the impact growth will have on indirect rates.

- **What role does an FPRA play in cost realism?** An FPRA can be used to evaluate cost realism. In some cases, the solicitation will

specifically state that a FPRA will be used in the evaluation. When reviewing rates, the presence of a binding FPRA takes precedence over seemingly realistic rates in a proposal.

- **What is the relationship between cost pools in the technical proposal and cost pools in the cost proposal?** The contractor must be consistent in how it allocates costs. Allocating certain costs to a new or lower cost center requires sufficient justification before the FAA can accept the costs as realistic. Effort should be allocated the same way in both the technical and cost proposals or the contractor should provide justification for the change that explains how requirements can be met given the change in allocation.
- **When indirect rates seem unrealistically or abnormally low, is an indirect rate cap appropriate?** Once it is established that indirect rates are too low, the FAA has the discretion of deciding if a rate cap or an upward adjustment is the best course of action. In the case *U.S. versus Compliance Corp.*, the Navy upwardly adjusted indirect rates, even though DCAA had recommended a rate cap. GAO upheld the Navy's decision based on DCAA's determination that the proposed rates were substantially lower than historical rates.

An upward adjustment of the indirect rates in addition to a cap is not allowed. A cap makes an offer more attractive because the contractor bears the risk of increases in cost. An upward adjustment decreases the chances for award by raising the total cost in the proposal.

10.7 SUMMARY

This chapter has discussed the composition of indirect rates, two types of indirect pools (overhead and G&A), rate projections, and the administration of indirect rates. The analyst should remember that an indirect rate is an indirect cost pool divided by an allocation base. Analysis of indirect rates requires analysis of the costs within the cost pool, the homogeneity of the cost pool, and the appropriateness of the allocation base.